Internal Revenue Service

memorandum

FI&P

date: DEC 26 1991

to: Director, San Francisco Appeals W:SF:AP
Attn: Gary Joyce

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [redacted]
Applicability of I.R.C. § 249

ISSUE

Whether I.R.C. § 249 applies to disallow a deduction claimed for the payment of repurchase premiums paid upon the exercise of convertible debentures.

CONCLUSION

I.R.C. § 249 applies and no deduction is allowed for the payment of repurchase premiums.

FACTS

[redacted] is a wholly owned domestic subsidiary of [redacted]. Under an Indenture dated [redacted], [redacted] issued [redacted]% sinking fund debentures in the principal amount of $[redacted] which matured [redacted], [redacted] capitalized and amortized its issue expenses.

The debentures were convertible into the common stock of [redacted] (now [redacted] from [redacted] to [redacted]. The conversion price was adjusted for stock splits, corporate reorganizations, and similar events. Holders exercising their conversion rights delivered their debentures to offices of [redacted]'s agents and received [redacted] (or [redacted]) stock plus cash in lieu of fractional shares. In [redacted] and [redacted], [redacted] issued [redacted] and [redacted] shares, respectively, of its common stock for [redacted] to use when its debentures were presented for conversion. [redacted] acquired [redacted] stock by paying [redacted] cash equal to the fair market value of the shares as they were issued. In addition, [redacted] had an option to redeem a portion of the debentures at redemption prices of [redacted] percent of principal in [redacted] and [redacted] percent of principal in [redacted].

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Under section 3.02 of the Indenture dated [redacted] the redemption of the debentures, at prices and dates set forth therein, is at the option [redacted] Section 4.01 gives the holder the option to convert at a price of $[redacted] a share. Nothing in the Indenture requires either the holder or [redacted] to exercise their rights at any time. The Indenture was amended in [redacted] changing the conversion price from a fixed price of $[redacted] a share to fair market value.

With respect to the debenture conversions in [redacted] and [redacted] deducted: (1) the excess of the value of the stock and money it transferred to holders who converted their debentures over the principal amount of the surrendered debentures, and (2) the unamortized issue costs for these debentures.

The agent disallowed deductions claimed for debenture conversion losses by [redacted] in [redacted] and [redacted] The agent asserted that the repurchase premiums were subject to disallowance under Code section 249 because the repurchase did not qualify for the grandfather rule contained in section 414(c) of the Tax Reform Act of 1969. The agent cited National Can Corp. v. United States, 687 F.2d 1107 (7th Cir. 1982) as further support for disallowing the repurchase premium deductions.

The taxpayer argues that section 249 does not apply to repurchase premiums paid pursuant to binding obligations incurred on or before [redacted] to repurchase at a specified call premium. The taxpayer states that [redacted] had a binding obligation to convert the debentures at a specified premium under the [redacted] indenture.

LAW AND ANALYSIS

Section 414 of the Tax Reform Act of 1969, Pub. L. 91-172, 1969-3 C.B. 10, 83, added section 249 to the Internal Revenue Code. Section 249 of the Code provides, in general, that no deduction shall be allowed to the issuing corporation for any premiums paid or incurred upon the repurchase of a bond, debenture, note, or certificate, or other evidence of indebtedness which is convertible into the stock of the issuing corporation, to the extent the repurchase price exceeds an amount equal to the adjusted issue price plus a normal call premium on bonds or other evidences of indebtedness which are not convertible.

Section 414(c) of the Act provides that section 249 of the Code shall apply to a convertible bond or other evidence of indebtedness repurchased after April 22, 1969, other than such a bond or other evidence of indebtedness repurchased pursuant to a binding obligation incurred on or before April 22, 1969, to repurchase such bond or other evidence of indebtedness at a specified call premium.

In Head Ski Co. v. United States, 323 F. Supp. 1383 (D. Md. 1971), aff'd per curiam, 454 F.2d 732 (4th Cir. 1972), and Southwest Grease & Oil v. United States, 308 F. Supp. 107 (D. Kan. 1969), aff'd per curiam, 435 F.2d 675 (10th Cir. 1971), the courts held that taxpayers could deduct the excess costs of repurchasing cable convertible evidences of indebtedness as ordinary and necessary business expenses. In these decisions the price paid was geared to the value of the stock into which the evidences of indebtedness could be converted.

In Head Ski Co., the court noted that section 249 of the Code, as enacted, specifically covers deductions for premiums paid for the redemption of convertible notes. The court observed that Congress was aware of the court cases construing section 1.61-12(c)(1) of the regulations in a manner contrary to the position of the Internal Revenue Service and that the intention of Congress was to enact legislation to change the law prospectively.

Section 1.249-1(f)(1) of the regulations states:

> (f) **Effective date--(1) In general.** Under section 414(c) of the Tax Reform Act of 1969, the provisions of section 249 and this section shall apply to any repurchase of a convertible obligation occurring after April 22, 1969, other than a convertible obligation repurchased pursuant to a binding obligation incurred on or before April 22, 1969, to repurchase such convertible obligation at a specified call premium. A binding obligation on or before such date may arise if, for example, the issuer irrevocably obligates itself, on or before such date, to repurchase the convertible obligation at a specified price after such date, or if, for example, the issuer, without regard to the terms of the convertible obligation, negotiates a contract which, on or before such date, irrevocably obligates the issuer to repurchase the convertible obligation at a specified price after such date. A binding obligation on or before such date does not include a privilege in the convertible obligation permitting the issuer to call such convertible obligation after such date, which privilege was not exercised on or before such date. (Emphasis supplied)

[redacted] apparently confuses the unilateral obligation of an option holder with the bilateral obligations of parties to a binding obligation. In addition to the last sentence of the above regulation which clearly provides that the options described in the indenture do not qualify for the grandfather treatment, there is other authority which discusses a term

substantially identical to "binding obligation", that is, the term "binding contract." The term "binding contract" was interpreted when the investment credit was repealed in 1986. House Report No. 99-426, 1986-3 C.B. Vol. 2, 161 states:

> For purposes of the general binding contract rule, a contract under which the taxpayer is granted an option to acquire property is not to be treated as a binding contract to acquire the underlying property. In contrast, a contract under which the taxpayer grants an irrevocable put (i.e., an option to sell) to another taxpayer is treated as a binding contract, as the grantor of such an option does not have the ability to unilaterally rescind the commitment.

Sections 3.02 and 4.01 of the indenture merely gave [redacted] and the holders, respectively, a privilege to call or convert the debentures as described in the above excerpt of the regulations.

In Clark Equipment Co. v. United States, 912 F.2d 113 (6th Cir. 1990), the court did not allow an issuing corporation to deduct the costs associated with converting bonds into stock of its parent. In Clark, the issuance occurred in 1966. The original indenture provided that the parent would effect the conversion. The indenture was amended in 1971 to specify that the subsidiary would effect the conversion. The court found that the issuing corporation "did not incur a binding obligation to convert the debentures until 1971, well after the effective date of section 249." Id. at 119.

Prior to reaching this conclusion, the court cited the first sentence of Treas. Reg. § 1.249(f)(1) with no mention of the succeeding sentences. The Government's brief, at 38 and 39, citing the unpublished district court opinion, merely states that the issuer "had no binding obligation to repurchase the debentures (i.e. to convert them) until 1971." There was no analysis regarding the underlined portion of the regulation.

The focus of the government's brief and the appellate court decision was on the fact that the taxpayer's obligation to perform if and when the option was exercised was not fixed until the date of the amendment to the indenture. The proper focus should have first been on whether there was truly a "binding obligation" as required by the emphasized portion of the regulations and the legislative history. In other words, the court's focus was on who was potentially obligated at the time in question and not on whether the obligation at issue was a "binding obligation" within the meaning of the regulations. In our view, there was no such obligation.

Similarly, the rights possessed by [redacted] and the holders were merely "privileges" to convert as described in the

emphasized portion of the regulations which do not rise to the level of a "binding obligation." At the time the bonds were issued, and up to the time of conversion, there was no guarantee that they would not remain outstanding until maturity. Accordingly, no binding obligation was in effect.

However, even if the "privilege" to call could be construed to be a binding contract, the indenture was amended in [redacted]. Therefore, the exception to the general rule of section 249 does not apply since the amended indenture, the provisions of which were effective during the tax years in question, was not in force until well after the effective date of section 249. That is, the amendment of the indenture should be treated as a new issuance for purposes of section 249. See Clark Equipment, supra at 119. Accordingly, the deductions in [redacted] and [redacted] for repurchase premiums are properly disallowed.

If you have any questions concerning this matter, please contact Joel Helke of this office on FTS 566-3345.

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